National Committee On
PUBLIC EMPLOYEE PENSION SYSTEMS (PEPS)

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JOINT STATEMENT OF JOHN W. MACY, JR.

AND HASTINGS KEITH, CO-CHAIRMEN,

NATIONAL COMMITTEE ON PUBLIC EMPLOYEE PENSION SYSTEMS

BEFORE THE

SENATE COMMITTEE ON GOVERNMENTAL AFFAIRS

SEPTEMBER 11, 1985

Mr. Chairman and Members of the Committee:

We appreciate very much your invitation to our Committee to present views regarding the characteristics of the new retirement system for federal employees entering service subsequent to December 31, 1983. For the record, our respective residences are 5047 Glenbrook Terrace, N. W., District of Columbia (Keith) and 1127 Langley Lane in McLean, Virginia (Macy). This statement is presented in our capacities as Co-Chairmen of the National Committee on Public Employee Pension Systems (PEPS).

The membership of the Committee appears on our letterhead; practically all the members are former elected officials or employees of the legislative and executive branches in national, state and local governments, and most are receiving pensions from one or more public retirement systems. PEPS is organized as a non-profit corporation and receives its financial support from contributions and grants from its members and private foundations and businesses. The Committee first came into being because of shared concerns about some of the equity and affordability aspects of public employee pension systems, especially the federal civil service and military retirement systems.

The Committee has conducted some original research, including a study of replacement ratios and the measurement of retirement income necessary to maintain pre-retirement consumption levels--"consumption maintenance" in contrast to "income maintenance". However, the bases for its considered views have relied extensively on data collected by others, including principally the research and evaluation arms of the Congress and the Federal Executive Branch (GAO, CRS, CBO, OMB, OPM, BLS and Census), previous study commissions, and private and non-profit organizations such as the Employee Benefit Research

Institute (EBRI), the Brookings Institution, and the National Bureau of Economic Research.

Drawing upon the foregoing resources, early this year the Committee adopted a list of essential components of a supplemental retirement plan for post-1983 hires within the context of a defined benefit structure; the list is appended. Coincidentally, its general thrust conforms rather closely to the conclusions of the Brookings research team which last year addressed overall issues associated with growing budget deficits. Regarding federal retirement systems, the findings, as reported by Dr. Alice M. Rivlin in the Brookings Review, Summer, 1984 were:

> Both the civil service and military retirement systems should be changed to bring them more in line with private-sector pension plans. For future retirees, initial benefits should be reduced somewhat and full benefits should be available only to those sixty-two years of age or older. Benefits for current and future retirees should be only partially indexed for inflation.

Our Committee compliments the sponsors of S.1527 for their initiative in introducing legislation that moves meaningfully toward redressing those aspects of federal pension systems targeted by the Brookings study--namely, increasing the age for unreduced benefits, reducing the level of future benefits, and partially, rather than fully, indexing for inflation. However, desirable as these steps are, they do not in our view go far enough to meet the critical problems of inequity and unaffordability that plague the present federal civil and military pension systems. We believe that S.1527 needs to be strengthened in several respects.

The normal retirement age should be increased to coincide with that of the Social Security system--namely, 65 initially and higher in later decades.

The factor multiplier for years of service should be reduced from 1.0% to 0.5% for years of service beyond 30.

The actuarial reduction for early retirement should be increased to six percent annually for all voluntary retirements below age 62; and a reduction of three percent annually should be imposed for the period 62 to 65.

The COLA provision should be changed to index only that portion of total federal pension benefits (including Social Security) which is equal to the Social Security maximum benefit (with amounts beyond that un-indexed).

Present employees not "approaching retirement age" (e. g. age 45) should be brought into the new system, with benefits pro-rated according to length of service in old and new systems, respectively.

Future pension payments made to retirees and survivors should fully or partially exclude the one percent "kicker" which was in effect from 1969 to 1976 from the calculations base.

Double counting of military service for both civil service and military retirement purposes should be prohibited.

Finally, projected Treasury revenue losses arising from exclusion from gross income of employee and employer contributions to the proposed thrift plan should be calculated; and such loss should be included in computing costs of the new system in comparison to the

present system.

The following paragraphs summarize our Committee's position regarding the major components of pension system cost in which we believe the provisions of S.1527 should be modified substantially.

Normal Retirement Age and Actuarial Reductions

We propose that the normal retirement age for the new system be 65 initially, with future increases as mandated by the Social Security Amendments of 1983, and with early retirement subject to a 3 percent reduction for each year age 62 to 65 and a 6 percent reduction for each year age 55 to 62. In contrast to current high rates, this represents a low rate of early retirement subsidization (full actuarial reduction at 55 would be 60%, in comparison to our proposed 51%--7x6% plus 3x3%).

We question the approach taken in S.1527, whereby the normal retirement age is pegged at 62 rather than 65 and whereby actuarial reductions are tied to whether or not the retiring employee has 30 years of service; this can create frequent "notch problems". More important, with continuing dramatic increases in life expectancy, it is fiscally unrealistic in our view to provide full benefits below the Social Security retirement age. We believe that the five percent reduction below age 62 specified in S.1527 for retiring employees with less than 30 years' service should be extended to all voluntary early retirements and be increased to six percent, with annual reductions of three percent for those retiring employees between ages 62 and 65.

Cost-of-Living Adjustments

We propose no COLA for the supplemental benefit for so long as the Social Security benefit is fully indexed. (For present retirees, we have for several years urged a capping of civil service and military COLAs at the level of maximum Social Security benefits--currently approaching $10,000). This approach is much more equitable and adequate for those on lower retirement incomes than by simply adopting a formula such as CPI minus two as provided in S.1527.

Thrift Savings Plan

As shown in the appended "Essential Components of a Supplemental Retirement Plan" for post-1983 federal hires, our Committee states under point XII: "The foregoing plan components provide adequate retirement income for the federal retiree. Consequently, the Committee believes a government-financed supplemental thrift/savings plan is not required."

The Committee recognizes that such plans are a growing part of the pension plans of larger corporations, and are particularly attractive to those in high income tax brackets because of the sheltering aspects. As we all know, sheltering of retirement contributions, especially employer contributions thereto, is an important and controversial item in the tax reform bills under consideration by the Congress.

The 1983 survey of Top 50 firms by the Wyatt Company showed that 39 of the firms had thrift/savings plans involving employer contributions, but with a few of these in "temporary suspension"--presumably recession-related. (The Wyatt Company, Top 50, Exhibit 6A, "Thrift/Savings Plans Covering Salaried

Employees of 50 large Industrial Companies", January 1, 1984, pp. 76-79.) In only 13 of the 39 did employer contributions fully equal or more than equal those of employees. In all of the 39 firms, employee contributions eligible for matching were limited to a specified percent of basic pay, and only a few of the 39 plans provided for immediate vesting of employer contributions. These and other conditions reduce the overall large firm average cost to under 2 percent of payroll. Stock option, employee ownership, and profit sharing, being considerably more concentrated in fewer employees, produce a total capital accumulation plan total cost of approximately 2 percent of payroll in larger private sector firms.

We believe that before including any thrift plan in legislation for a supplemental retirement system for new federal employees, your Committee and the Congress should ascertain the estimated revenue loss to the Treasury and include such loss as a part of the cost of the plan in comparison with the existing Civil Service Retirement System. This is relevant not only to any matching government contribution but to the total employee contribution--both matched and unmatched--as well.

We certainly are in sympathy with the use of public and private pension funds for private sector capital accumulation purposes in light of a national savings rate far below that of some of our foremost international economic competitors. If provision for voluntary contributions to a savings plan without government matching (which is not ruled out in our set of proposed components), the revenue loss cost of such an arrangement should be offset by an appropriate modification of some other part of the pension system formula.

We recognize a definite and significant relationship between the thrift plan proposed in S.1527 and the option offered to employees under the present

retirement system to transfer into the new system. Employees not "approaching retirement age" need to be brought under the new system. Our Committee has suggested that in order to avoid too wide a chasm between employees in the old and the new systems and to lower future costs, those employees under age 45 as of the effective date of enactment should mandatorily be brought into the new system, with eventual benefits pro-rated between the old and new formulas based on the years of service under the respective systems. (e.g. assuming factor multipliers and retirement ages suggested above, and assuming initial entry into federal service at age 25, an employee at age 44 with 19 years of service coming into the new system would reach a replacement ratio of 45.25% at age 55, plus Social Security, both fully collectible at age 65; a 35-year-old empoyee would reach a replacement ratio of 36.25% at age 55--10 years under the old system for 16.25% and 20 years under the new system for 20%.)

In addition to the foregoing comments and recommendations regarding the four major cost aspects of S.1527 which we believe need substantial tightening, we would like to submit a few additional items of federal pension system policy which we would urge your Committee and the Congress to consider when enacting a supplemental pension system for new federal hires.

Method and Level of Funding

The overriding need here is for full cost disclosure in such terms as to minimize the continuing argument about meaning and accuracy of figures. To this end we propose that:

(1) each agency include in its budget the annual estimated actuarial cost as a percent of payroll, exclusive of any employee contributions that might be mandated for the supplemental system; (2) the consolidated balance sheet of the U. S. Government be

required to reflect the accrued liability for both the new and the old systems, with annual increases in such accrued pension liabilities to be included as costs in the President's unified budget; and (3) full funding of the entry-age normal cost through agency inclusion in annual budgets pursuant to (1) above; (4) a separate trust fund be established for the new plan. This would facilitate the need for "full disclosure" and the monitoring of the fiduciary responsibility of the trustees. In general, it will enhance fiscal discipline.

Various methods for handling the amortization of unfunded liabilities comprise difficult and controversial problems and require further study.

To repeat, all projected pension costs should be faced both initially and continuously thereafter.

To date, most of the analysis of federal pension proposals done by the Congressional Research Service has been based on measuring entry-level normal cost and wage replacement ratios. While these are important evaluation criteria, they do not tell the entire accounting story. It is still necessary to provide financial projections of the Trust Fund assets, liabilities, receipts and disbursements on an accrual basis in order to assess the financial impact of the various proposals. While entry-level normal cost provides the best long-term indicator of adequacy in pension costing, we need an intermediate projection (5-10 years) for the Stevens-Roth bill and the other plans which would show the following: (1) Additions to the Fund, (2) Deductions from the Fund, (3) Net Assets Available for Benefits, (4) Actuarial Present Value of Accumulated Plan Benefits, and (5) Unfunded Liability.

An accounting model for preparing projections of the Trust Fund under the various proposals should be based on GAO supporting instructions to P.L.95-595.

Recovery of "Kicker" Benefits

Retirees who benefited from the compounding effects of the one per cent "kicker" which was in effect from 1969 to 1976 (and costing an estimated $30 to $40 billion over the life expectancies of the retirees and their survivors) should receive no COLAs until the CPI rise is such that past costs attributed to the kicker have been recovered. In addition to over-compensating retirees, the kicker substantially and unfairly widened the gap between retirees and active duty employees. To the extent feasible, the pre-kicker relationship should be restored.

Survivorship and Disability

Survivorship coverage for spouses should be automatic rather than elective; criteria for disability benefit eligibility should be the same as those for Social Security Disability Insurance; and a percentage cap, at a level determined by Congress, should be placed on total disability payments to an individual from private pension plans, Social Security and other employer- or government-sponsored plans--the cap being set at a percentage of final annual pay prior to disability.

Double-counting of Military Service

In legislating the supplemental pension system, the Congress should prohibit the continuation of the practice whereby time spent in military service is counted in the twice in determining the benefits of the federal workers who participated in both programs. In view of the administrative problem in implementing this prohibition, the DOD and the OPM should be mandated to develop the necessary processes to avoid the duplication of

retirement credit.

Long-range Consequences

We wish to emphasize the urgency of this problem. We believe the plan that we have proposed after extended study provides the most equitable and affordable approach to a new supplemental plan in which Social Security is a fundamental and universal base. The PEPS supplemental plan offers a pension which is more nearly comparable to those of the private sector. These changes are essential to sound public policy for the future to assure an adequate retirement level for the civil servant and lessen the heavy burden on the American taxpayer.

What started out as a good system in 1920 got out of hand in the 1960s and 1970s. We radically improved the pay of the rank and file civil servant and almost simultaneously introduced indexing. The end result is that our gross liabilities are increasing at about $50 billion per year.

Because of these inequities, it has become increasingly clear that we are threatened by imports from countries which do not have such extraordinarily generous pension systems. We are fast approaching the point of which Adam Smith wrote in the eighteenth century when he stated

> When national debts have once been accumulated to a certain degree, there is scarce, I believe, a single instance of their having been fairly and completely paid. The liberation of the public revenue...has always been brought about by bankruptcy; sometimes by an avowed one, but...frequently by a pretended payment.

We played a key role in the shaping of the nation's retirement policy. We know at firsthand of the extraordinary inequities. We believe substantial changes such as we have proposed before this and earlier Congresses must be made in the Civil Service Retirement System--both currently and prospectively. Only if we take these steps can we avert the crisis which we helped to create.

Thank you, Mr. Chairman, and Committee Members. This concludes our statement.

Essential Components of a Supplemental Retirement Plan for Federal Employees Covered Under the Social Security Amendments of 1983, as Proposed by The National Committee on Public Employee Pension Systems (PEPS)

I. Retirement Age:

A. Normal Retirement Age will be the age when unreduced Social Security Old Age Insurance benefits become available (currently age 65 with future increases mandated by Social Security Reform Act of 1983).

B. Early Retirement:

1. Age 62-Normal Retirement Age: Employees with 5 or more years of service will incur a 3 percent reduction in benefit amount for each year prior to Normal Retirement Age that retirement commences.
2. Age 55-61: Employees with 5 or more years of service will incur 6 percent reduction in benefit amount for each year prior to age 62 that retirement commences, in addition to reductions listed in I.B.1.[1]

II. Factor Multiplier:

A. The factor multiplier will be 1.0% times years of service, up to 30 years of service, and

B. 0.5% times years of service, for service beyond 30 years.

III. Final Average Pay:

Final average pay will be defined as average of highest five years' salary.

IV. Vesting:

Full vesting of all credited benefits after 5 years of service.

V. Employee Contributions:

New employees will make no contribution, except to Social Security.

VI. Financing of Supplemental Plan:

All contributions will be made by employing agency, with each agency to include in its budget the annual estimated actuarial cost.

[1] The reduction in benefits for an individual retiring at age 55 would be 51% (7 times 6 percent plus 3 times 3 percent) with a full actuarial reduction being about 60%, these suggested reductions provide some subsidization of early retirement, thereby allowing some desirable flexibility to both agencies and employees.

Adopted 1/24/85

VII. Cost of Living Adjustments (COLAs)

Inasmuch as inflation protection will be borne by Social Security portion of retirement benefits, no automatic COLAs are provided in the supplemental portion of the plan.

VIII. Survivorship Benefits:

A. Rather than an elective system as in the present plan, supplemental plan will provide <u>automatic</u> coverage for the surviving <u>spouse</u>[2] at no cost to the employee.
B. Eligibility will be limited to the surviving spouse of a retired employee, or spouse of an employee qualified for retirement but still actively employed.
C. The automatic survivorship benefit will equal 50 percent of supplemental benefit; if death occurs before normal retirement age, benefit will be 50 percent of benefit computed as for early retirement in I.B.1. and 2., above.
D. Employee will be allowed to elect other survivor options on an actuarially equivalent basis.

IX. Disability Benefits:

A. Criteria for eligibility will be the same as those for Social Security Disability Insurance.
B. The disability benefit will be equal to the lesser of the accrued benefit under supplemental plan for credited service to age 65. The benefit will commence after six months of disability.
C. In no event shall total disability payments from Social Security and employer- or government-sponsored plans, including sick leave, exceed a specified percentage[3] of final annual pay prior to disability.
D. The above assumes a full or partial continuation of salary for up to six months under an accident or sickness plan.

X. Funding:

A. The consolidated balance sheet of the U.S. Government will be required to reflect the accrued liability for all federal pension programs. Annual increases in the accrued pension liabilities and current employer payments to the CSRS Trust Fund will be included as costs (budget authority or obligations) in the President's unified budget.
B. The normal cost will be fully funded. Various methods for handling the amoritization of the unfunded liability require further study.

[2] "Surviving spouse(s)" would need to be defined by the Congress.

[3] As determined by the Congress (e.g., 60, 80, etc. percent).

XI. Coverage of Present (pre-1984) Employees and Retirees:

A. Those employees under age 45 as of January 1, 1986 will be brought into the new system, with a pro-ration applicable to service and consequent contributions to existing CSRS. The remainder of Civil Service employees will be provided a one-time election to join the Social Security system and to be covered by the new CSRS program.

B. For those employees not covered by the supplemental system, COLAs will be based on 100% of the CPI applied to benefits not in excess of the primary Social Security benefit payable to a person who has always had maximum covered earnings and who attains normal retirement age (currently age 65) in the current year. Current employees' initial retirement COLA will not be payable until attainment of age 62.

C. Retirees receiving pensions in excess of the primary Social Security benefit as defined in (b) above and who benefited from the compounding effects ot the "1% COLA Kicker" (in effect from 1969 to 1976) will receive no COLAs until the CPI undergoes a percentage increase equal to that of the affected cohort's COLA percentage increase.

XII. Thrift/Savings Plans:

The foregoing plan components provide adequate retirement income for the federal retiree. Consequently, the Committee believes a government-financed supplemental thrift/savings plan is not required.

NOTE: The foregoing set of components do not purport to deal with all of the issues involved in the creation of a new retirement system connected to Social Security (e.g., early retirement due to reductions in force (RIFs) and severance pay provisions related thereto; the counting of military service in other pension programs; foreign service retirement; retirement from hazardous employment - public safety, air traffic control, etc.)